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Ashmore

Silence is golden

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Despite supporting sanctions against Russia the EU has adopted a relatively low profile on the Ukraine question compared to the US. This is deliberate, understandable, tactical, and significant, in our view. We explain why we believe the current tensions between Russia and the US will eventually give way to a diplomatic solution led by the EU. Tensions return in the Middle East. Korea grows more than expected. We see signs of behind-the-scenes talks between the government and the opposition in Thailand. Hungary takes measures to aid liquidity in local markets. Mexico finally moves onto secondary legislation for recently passed reforms. Turkey's central bank holds the line as the government seeks to boost the credit-led expansion with government guarantees for major infrastructure projects. China also pushes infrastructure investments accompanied by easier credit for the rural sector. Poland announces that its 2014 financing needs have mostly been met.

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Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	993	–	-1.73%
MSCI EM Small Cap	1039	–	-1.62%
MSCI FM	661	–	-0.16%
GBI EM GD	6.86%	–	-0.63%
ELMI+	3.88%	–	-0.35%
EMBI GD	5.52%	283 bps	-0.26%
EMBI GD IG	4.69%	195 bps	-0.14%
EMBI GD HY	7.55%	510 bps	-0.39%
CEMBI BD	5.39%	303 bps	0.14%
CEMBI BD HG	4.47%	211 bps	0.17%
CEMBI BD HY	7.30%	494 bps	0.06%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1863	-0.43%
VIX Index	14.06	6.11%
5 year UST	1.74%	2 bps
10 year UST	2.68%	-4 bps
US HY	5.31%	0.17%
European HY	4.43%	0.24%
EURUSD	1.3865	0.52%
USDJPY	102.32	-0.28%
Brent	109.50	-0.44%
Copper	315.52	2.31%
Gold	1301.19	0.88%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

- **Russia and Ukraine:** Despite supporting sanctions against Russia, it is notable how the EU has been relatively quiet on the Ukraine question compared to the US. At first sight, the EU's low profile is curious when you consider that the EU's stake in the conflict is far, far greater than that of the US. Why is the US so vocal, while the EU is so silent?

We think the reason is that we are still in the escalation phase of this conflict. During this phase it makes sense to let the US take the lead. The US has much less to lose from a serious deterioration in relations with Russia. After all, the two countries have relatively few mutual interests, and on the question of gas the US could stand to gain from further escalation, at least over the medium term.

On the other hand, the mutual interests between EU and Russia are enormous. They include not just energy, but also broader economic ties, financial flows, and the simple fact that Russia and EU are right next to each other geographically. Neither side can afford to seriously damage ties. This makes the EU's low profile approach entirely understandable and deliberate, but also tactical and significant as a pointer to the eventual resolution to the Ukraine situation.

We think the Ukraine conflict will ultimately be resolved through an agreement between the EU and Russia. The EU is deliberately not matching the aggressive rhetoric from the US in order to leave a window open for a diplomatic solution, which, we think, the EU will lead and shape. As long as this window is open it is likely that the conflict will be resolved diplomatically.

In our view, the main question is not whether a solution will be found, but when. There is still scope for further escalation near-term before things get better. Both Russia and the US are still publicly adopting very aggressive positions vis-à-vis each other. This encourages extremist elements on the ground within Ukraine to step up their actions, but we believe that these elements can be reined in very quickly should a breakthrough appear possible at a higher level.

Also, the Ukrainian elections are still some time away and Russia will want to ensure that question marks are raised about the legitimacy of the election outcome ahead of the fact.

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Emerging Markets

On the other hand, further escalation is already having economic costs, especially for Russia. S&P's downgrade of the credit this past week is an example. Further sanctions would be another cost. The Russian central bank's decision to raise rates by 50bps to 7.5% is a third example. Business confidence will also be hurt by the lingering uncertainty.

On the issue of sanctions, more Russian companies are at risk of being targeted by US OFAC (Office of Foreign Assets Control) sanctions, following the inclusion of Bank Rossiya and Chernomornaftogaz on this list. But who would get hurt by such a move, Russia or Western interests? OFAC sanctions could bar some investors from holding the Russian names in question, forcing them to sell positions at low levels and thus crystalizing mark to market losses. Others could be afflicted if the names are removed from fixed income benchmark indices. In equities, questions of country and company inclusion in benchmarks tends to be determined by users. In fixed income, index inclusion tends to be more rules- based. For example, 'Index replicability' is the main principle used by JP Morgan as the basis for including names in their indices. Whether index providers believe that the 'loss' of investors subject to foreign imposed sanctions constitutes enough of a challenge to 'index replicability' to justify dropping the names from the market's benchmark indices remains to be seen; after all there are many investors and market makers in Russian assets outside of the US that would not be subject to, say, OFAC sanctions. This poses an interesting question to index providers in the event of new sanctions on index names: Can the index providers continue to be neutral or are they likely to be swayed in the interests of one particular stakeholder group, such as the US government or non-US clients? Of course, whether or not a name appears in an index does not, in itself, impact that name's ability or willingness to pay. In general, we think investors should be prepared to expose themselves to off-benchmark securities in Emerging Markets, not least because 89% of all fixed income securities are off-benchmark anyway.

While the Ukraine situation is likely to inflict economic pain on Russia – which will ultimately hurt President Putin – it is also clear that Russia's credit fundamentals are extremely strong. Net of official fiscal reserves, Russia's total public debt to GDP ratio at the end of 2013 was just 1.5%. As of 18 April, Russia's foreign exchange and gold reserves amounted to USD 482bn, surpassed only by China, Japan, Saudi Arabia, and Switzerland (Source: Ashmore/Bloomberg). Moreover, a change in macroeconomic policy adopted after 2008/2009 away from fixed towards a more flexible exchange, means that a weaker Ruble actually improves the public finances, thus improving the government's ability to pay. Besides, Putin is popular. In other words, Russia can stomach a lot of pain, both economically and politically.

We think investors should bear these factors in mind and not base their decisions on the headlines emanating from the heated public spat between the US and Russia, or questions of index eligibility. Investors should focus on value. Tensions may escalate further in the near-term, but this crisis looks likely to be resolved diplomatically. Given Russia's ability and willingness to pay, we think the right strategy is to add at weak levels, not to sell at or near the bottom.

We note in passing that the IMF looks set to approve a USD 17bn support package for Ukraine, possibly at a meeting on 30 April.

- Middle East: Palestinian factions, Hamas and Fatah, have reconciled with the view to forming a unity government. This sign of greater unity among Palestinians suggests less stress, which may ultimately be due to a better funding situation. If this is the case, one way to read this is that Bashar Hafez Al-Assad's gains in the Syrian civil war are allowing more support to reach Palestinians from Iran via Syria. Israel has already responded with alarm. This suggests that tension may now increase in the Middle East. It is noteworthy therefore that Putin last week called for peace talks to resume on the Syrian situation. Assad's stronger position in Syria means that Putin has the stronger hand, so it makes sense he plays it. Rising Middle East tensions, should they occur, could be supportive for oil prices, which in turn would strengthen Russia.

- South Korea: South Korea's economy expanded faster-than-expected in Q1 2014. Real GDP expanded by 3.9% yoy in Q1 compared to a median expectation of 3.8% and a growth rate in Q4 2013 of 3.7%. The element of surprise was from Korea's net export performance.

- Thailand: Thailand's Prime Minister Yingluck Shinawatra said she would step down if it was in the best interests of the country. Thaksin Shinawatra, former prime minister and powerbroker behind the scenes, voiced similar sentiments. This is positive, because it suggests that there are important negotiations taking place to resolve the political crisis in Thailand. Whether that involves fresh elections remains to be seen. An election would involve the same individuals and would yield the same result as February's election. A technocratic administration is one possible outcome as protests have lost popular support.

- Hungary: The central bank introduced fresh measures to increase the attractiveness of local securities relative to foreign securities. The measures were aimed to increase liquidity in the long end of the Hungarian local curve as part of a broader effort to reduce the country's problem of excessive foreign currency denominated debt, particularly among households. These are market-friendly measures. Meanwhile, the rate of unemployment which was expected to continue at the same 8.6% level seen in February, fell to 8.3% in March.

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Emerging Markets

- **Mexico:** After passing sweeping structural reforms over the past couple of years, Mexico's legislators are now finally getting ready to approve supporting secondary legislation. This has been slow in coming, which explains in part why Mexico's economy has been slow to rebound despite the important reforms. But this now looks set to change. The majority leader from the governing PRI party in the Lower House this week announced special sessions to approve secondary legislation for the telecom and energy bills passed last year. The sessions are scheduled for May and June.
- **Turkey:** The central bank surprised the market by not announcing fresh easing measures in its monetary policy decision last week. All rates, except for a little-used late liquidity window lending rate, were left unchanged. The benchmark repo rate was kept at 10%. Turkey's central bank was late in responding to Turkey's macroeconomic imbalances, but was eventually prompted to hike earlier this year. By then, the currency had weakened significantly resulting in a pass-through to inflation. We expect these inflationary pressures to wane over the course of the year, while the current account should improve significantly on the back of a weaker TRY and lower domestic demand. In other news, the government is considering legislation that would permit government guarantees for infrastructure projects of size greater than TRY 1bn. Such guarantees would constitute a contingent liability for the government, that is, it only becomes a problem to the extent that projects fail. Turkey has a pipeline of close to USD 100bn of PPP projects. GDP is about USD 840bn. The initiative provides a pointer for the future direction of Turkey under prime minister, Erdogan – the government will continue to promote a credit and investment led approach to growth.
- **China:** HSBC's advance reading of April's Purchasing Managers Index (PMI) came in line with expectations, rising slightly relative to March. PMI was 48.3 compared to 48.0 last. The State Council announced 80 new infrastructure projects. The projects will stimulate growth during the current soft phase, while support long-term growth as China transitions from export to domestic demand led growth. The PBOC also announced a reduction in the reserve requirements for commercial banks specialised in rural lending. The reserve requirement will be lowered by 2% for county-level banks. The measure is likely to inject about RMB 300bn into rural sectors (compared to total daily interbank lending volumes of RMB 4trn). Rural banks account for 13% of China's banking sector.
- **Poland:** The government announced that it has met 80% of its funding needs for 2014 after a successful auction of bonds.
- **Colombia:** The central bank raised rates by 25bps to 3.5% in a forward-looking move intended to snuff out possible increases in inflation expectations as the economy picks up. Recent data has beaten expectations, both with respect to growth and inflation. Colombia's economy is resilient, benefitting from deep economic reforms implemented during the early part of President Santos' administration.

Policy decisions:

- Bank of **Thailand** left rates unchanged at 2.0%
- **Russia's** central bank raised rates by 50bps to 7.5%
- **Mexico's** central bank left rates unchanged at 3.5%
- **Colombia's** central bank raised rates by 25bps to 3.5%

Global backdrop

The US economy once again failed to achieve 'exit velocity' at the start of this year – contrary to the expectations of virtually every US economist [in the world?]. This was due to a combination of inventory adjustment (which economists mysteriously missed) and a spell of bad weather (which was played up to cover up for the forecast error). Still, neither inventory corrections not winter weather are sustainable. The US economy will gradually pick up steam for the rest of 2014, albeit fairly modestly given the continuing burden of debt.

Indeed, the reason why US growth continues to 'under-deliver' is that households are still deleveraging. Consumer demand is not responding in the usual way. We expect another two years of household deleveraging, but once it is finally over the US economy should be able to stage a more decent recovery, not least because of the relative health of US corporate balance sheets and the country's solvent banking system.

The Fed is acutely aware of the slowly fading 'headwinds' (euphemism for household debt) and the risks associated with endless money printing. It has therefore appropriately begun to taper. At the same time, the Fed is aware that the US treasury market is keen to sell bonds at the first sign of stronger economic data. To prevent a repeat of the debacle last year when bond vigilantes successfully forced the Fed to U-turn on tapering before the policy had even began, the Fed has this year created substantial ambiguity about its policy stance.

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Global backdrop

First, the FOMC has deliberately chosen to be hawkish on the 'dots'. This was done not as a precursor for hikes, but in order to build credibility in the hope that the Fed will not have to hike in order to manage inflation expectations. Secondly, Janet Yellen chose to be very dovish in April when she said that unemployment may have to fall as far as 5.2% before the Fed hikes rates. Superficially contradictory, both interventions are, in our view, consistent with a dovish stance for the Fed heading into a period of possibly stronger US data.

Even so, we are now in a period where real rates are volatile, albeit within relatively narrow bounds. US Treasury bond yields are set to rise should US data pick up after the current inventory and weather-led soft patch. In the context of still low inflation, higher nominal Treasury yields translate into higher real Treasury yields one to one. But the extent of real rate volatility will remain contained by the fragility of an economy labouring under excessive debt. Spikes in real yields should therefore be bought. All in all, we are in a period of managed real rate volatility in the context of still relatively subdued growth. Modest real rates volatility translates into modest currency volatility; indeed, we think currencies remain range-bound for the foreseeable future as they have been for some time. This situation could last another two years.

Turning to specific global developments this week, US data releases disappointed at the margin when claims for unemployment benefit rose, new homes sales fell sharply, and Markit's preliminary PMI release for the month of April was softer than expected. Other data were in line with expectations. The FOMC is meeting on 30 April and is likely to continue to reduce the pace of asset purchases, in our view. Next week also brings US payroll data, a key release. In Europe, manufacturing surprised to the upside, led by Germany, where IFO numbers also beat expectations. France on the other hand had weaker data. Inflation in Japan disappointed slightly for April as core inflation clocked 2.0% versus 2.1% expected. The lower-than-expected inflation print followed comments by Bank of Japan officials that the central bank was worried about the bond market's failure to build expectations of higher inflation into bond prices. New Zealand's central bank hiked for the second time (after being the first of the developed central banks to begin a hiking cycle since the crisis), while Denmark's central bank raised the rate on certificates of deposit back to positive territory.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.1%	-0.4%	-0.5%	-3.5%	11.9%
MSCI EM Small Cap	0.2%	3.8%	-0.1%	-2.5%	15.8%
MSCI FM	5.8%	14.4%	30.3%	9.0%	13.9%
S&P 500	-0.37%	1.43%	20.04%	14.19%	19.03%
GBI EM GD	0.15%	2.05%	-9.46%	0.11%	8.26%
ELMI+	-0.14%	0.39%	-2.69%	-1.79%	3.51%
EMBI GD	0.75%	4.51%	-1.13%	7.10%	10.86%
EMBI GD IG	0.82%	4.51%	-3.32%	5.92%	8.67%
EMBI GD HY	0.62%	4.55%	2.93%	9.27%	14.00%
5 year UST	0.31%	1.14%	-2.28%	2.87%	3.10%
7 year UST	0.61%	2.67%	-3.97%	4.33%	4.17%
10 year UST	1.17%	5.55%	-4.01%	6.66%	4.75%
CEMBI BD	0.69%	3.50%	1.01%	5.73%	11.22%
CEMBI BD HG	0.78%	3.83%	0.88%	6.27%	9.79%
CEMBI BD HY	0.51%	2.81%	1.35%	5.00%	16.12%
US HY	0.56%	3.82%	7.49%	9.63%	17.23%
European HY	0.81%	4.22%	12.11%	13.21%	20.64%
Barclays Ag	0.94%	3.37%	2.55%	2.45%	5.14%

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